Issue 8

PALOS
INVESTMENT FUNDS

February 23, 2017

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Palos Weekly Commentary

■ Palos Income Fund

By Charles Marleau

ECN is Building a War Chest

On February 21, 2017, ECN Capital (TSX: ECN) announced that it entered into an agreement to sell its US commercial and vendor finance business to PNC Financial Services Group for USD$1.253 billion (CAD $1.625 billion). The transaction was done at a very attractive multiple. The asset was sold at 1.5x price to book (P/B). The last similar transaction was done at 1.0X P/B which occurred in June 2016 when Laurentian Bank acquired CIT Canada. This transaction will allow ECN to concentrate on the US middle-market finance space (Companies having between $10milion and $1 billion of Revenue). With this transaction, they are getting closer to their goal of having enough liquidity to make a significant strategic transaction.

We believe that ECN will continue to grow its capital via preferred shares and dispositions of non-core assets such aviation and rail loan book. If successful on all fronts, this would bring the ECN war chest to approximately CAD $5 billion.

After the announcement, the stock rose by 12.8% to approximately $3.60, which implies 0.80x P/B. With the stock being fundamentally inexpensive. We see ECN as a great investment opportunity as the market is over-discounting the company.

Chart 1: Palos Domestic Funds versus Benchmarks (Total Returns)*

	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL 100	$10.04	2.92%
Palos Equity Income Fund - RRSP	PAL 101	$6.57	2.97%
Palos Merchant Fund L.P. (Dec 31, 2016)	PAL 500	$4.33	-16.73%
Palos IOU High Yield Fund (Jan 31, 2017)	PAL 701	US $7.45	-0.06%
Palos WP Growth Fund - RRSP (Feb 21, 2017)	PAL200	US $10.15	1.50%
S&P TSX Composite			3.52%
S&P 500			5.91%
S&P TSX Venture			10.12%
Bloomberg USD High Yield Corporate Bond Index 1 to 3 Year			2.34%

Chart 2: Market Data*

	Value
US Government 10-Year	2.37%
Canadian Government 10-Year	1.67%
Crude Oil Spot	US $54.36
Gold Spot	US $1,250.20
US Gov't10-Year/Moody BAA Corp. Spread	222 bps
USD/CAD Exchange Rate Spot	US $0.7631

* Period ending Feb 23, 2017

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■ What is New on the Macro Level?

By Hubert Marleau

Insight on Productivity

Productivity is not a very attractive sector of macroeconomics because it takes a long time to see its effect on the economy. This may be why it is often neglected. However, a lack of increase in productivity will, in the fullness of time, cause economic prosperity to stop, social upheaval to rise and political discontent to spread. The lackluster performance of productivity has caused the return investors get from workers to be in a long-term decline. At this rate, productivity growth rate is heading toward zero. If it is not restored, income will stagnate, growth will decrease, inflation will increase and inequalities will become inevitable.

Since the end of the last recession, most of the economic growth has been driven by labor, not productivity. Since then, our numbers show that the growth of labor productivity averaged about 0.5%, while employment increases provided the bulk of GDP growth. This means that the standard of living of Americans has not changed much. Herein lies the fear of the populace. A small difference in productivity growth can bring about dramatic change in prosperity. For example, if productivity was to increase at the annual of 0.5%, it would take about 150 years to double the standard of living. On the other hand, if we could change its trajectory and hold it steady around 2.5% per year, it would take only 25 years to double.

The decline in the pace of productivity is not a complete mystery. In a recent "Gold Investors" article, Alan Greenspan explains the "productivity puzzle" in a simple and elegant manner. "We have been through a protracted period of stagnant productivity growth, particularly in the developed world, driven largely by the aging of the baby boom generation. Social benefits are crowding out gross domestic savings, the primary source of funding investment, dollar for dollar. The decline in gross domestic savings as a share of GDP has suppressed gross non-residential capital investment. It is the lessened investment that has suppressed the growth in output per hour globally. Output per hour has been growing at approximately 0.5% annually in the US and other developed countries over the past 5 years, compared with an earlier growth rate closer to 2%. As productivity growth slows down, the whole economic system slows down. That has provoked despair and a consequent rise in economic populism from Brexit to Trump. Populism is not a philosophy or a concept, like socialism or capitalism. Rather it is a cry of pain, where people are saying: Do something. Help! That's it, the whole thing in a nutshell. There are too many retirees for existing workers to adequately support them, and that's an aggregate drain on savings. Savings fuel investment, so drained savings hurt investment. No investment, no jobs, no nothing---and everybody's angry."

The aforementioned narrative takes me to a book written by Neil Howe and William Strauss that I read some 20 years ago. The book argues that history generally moves in 80-year cycles, with each cycle ending in a crisis that destroys the old order and ushers in something new. The USA had three turning points: the American Revolution, the Civil War and the Great Depression. We are currently approaching the fourth turning point. One that emanates from the financial crisis of 2008. Two more recent books, "The Fourth Industrial Revolution" by Klaus Schwab and "The Fourth Revolution: The Global Race to Reinvent the State" by John Micklethwait, also preach a similar historical determinism. Neil Howe, in a recent interview with RiskHedge's Jonathan Roth, explained that Steve Bannon, along with a few others, are getting an interesting lesson from these books, particularly "The Fourth Turning". Howe predicts that this era will see the successful merging of economic populism and cultural and social conservatism. Bannon is a proponent of Neil's theory and feels that Trump is a blunt instrument that can implement what is needed. If there is any truth to this, the new period will be one of strong and centralized government power and a reimagination of the economy. Howe calls it "Regeneracy". Steve Bannon, the chief strategist of the Trump administration, is on the cover of last week's Time magazine. He is on a mission. If productivity turns up, as we expect, many believe that it will be a failed attempt. It would bring about significant improvements in social and economic conditions.

If you have any questions about the weekly commentary, the securities that we follow, or investment ideas, please contact us at info@palos.ca